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Client Alert

Current Issues Relevant to Our Clients

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FINRA Seeks Comments on New "Pay-to-Play" Rule

The Financial Industry Regulatory Authority, Inc. ("FINRA") recently proposed new "pay-to-play" rules that would regulate the activities of FINRA member firms engaging in distribution or solicitation activities with government entities on behalf of investment advisers (the "FINRA Pay-to-Play Rules"). The proposal is modeled after and intended to address a provision of Rule 206(4)-5 (referred to herein as the "Advisers Act rule") under the Investment Advisers Act of 1940 (the "Advisers Act"). Effective April 1, 2015, the Advisers Act rule will prohibit an investment adviser from paying a FINRA member firm to solicit a government entity for investment advisory services unless the FINRA member firm is subject to an equivalent FINRA pay-to play rule or otherwise meets the definition of a "regulated person" under the Advisers Act rule. The FINRA Pay-to-Play Rules are designed to address this requirement under the Advisers Act rule. FINRA is proposing Rule 2271 (Disclosure Requirement for Government Distribution and Solicitation Activities), Rule 2390 (Engaging in Distribution and Solicitation Activities with Government Entities) and Rule 4580 (Books and Records Requirements for Government Distribution and Solicitation Activities). Comments on the proposal are due by December 15, 2014. A copy of the FINRA notice is available here. For information about the Advisers Act rule including the Securities and Exchange Commission's (the "SEC") extension of the compliance date on the prohibition on payments to certain third party solicitors see our Client Alerts available here and here.

Why did FINRA Propose "Pay-to-Play" Rules?

In July 2010 the SEC adopted Advisers Act Rule 206(4)-5 addressing pay-to-play practices by investment advisers. The Advisers Act rule generally prohibits an investment adviser from providing advisory services for compensation to a government entity for two years after the adviser or any of its covered associates make a contribution to an official of the entity absent an available exemption. The Advisers Act rule also prohibits advisers from providing direct or indirect payments to any person who solicits a government entity for investment advisory services on behalf of an adviser unless the soliciting person is a "regulated person". FINRA member firms are included in the definition of "regulated person" as long as (1) FINRA rules exist that prohibit member firms from engaging in distribution or solicitation activities if political contributions have been made and (2) the SEC finds such rules to impose equivalent or more stringent restrictions on member firms than the Advisers Act rule. Current FINRA rules do not include a pay-to-play prohibition that meets this requirement. As a result, FINRA must adopt its own rule to enable member firms to continue to engage in government entity solicitation activities for investment advisers to rely on the Advisers Act rule.

Proposed FINRA Pay-to-Play Rules

The proposed FINRA Pay-to-Play Rules would prohibit a **covered member** from engaging in distribution or solicitation activities for compensation with a government entity on behalf of an **investment adviser** that provides or is seeking to provide investment advisory services to such government entity within two years after a **contribution** to an **official of the government entity** is made by the FINRA member or a **covered associate**. This prohibition is modeled on the Advisers Act rule. Like the Advisers Act rule, absent some exception under the rules, this effectively imposes a two-year "cooling off period" on a FINRA member from engaging in government entity solicitation activities for investment advisers after the covered member or its covered associates make any contribution to an official of the government entity. This two year look back applies to any person who becomes a covered associate, including a current employee who has been transferred or promoted to a position covered by the proposed rule. As a result, when an employee becomes a covered associate, the FINRA member firm must look back in time at that employee's contributions to determine whether the cooling off period would still apply to the covered member. If a contribution was made by an employee that is newly within the definition of a covered associate less than two years ago, then the cooling off period runs until the end of the two year period from the covered associate's contribution.

What is a "covered member"?

A "covered member" under the proposed rules includes any FINRA member firm except when the member is engaging in activities would cause the member to be a

municipal advisor as defined under the Securities Exchange Act of 1934 ("Exchange Act"). Where a member firm is engaged in such activities it is possible the firm may be required to register as a municipal advisor and under such circumstances MSRB rules applicable to municipal advisors would apply.

What "investment advisers" does the rule apply to?

The proposed rules would apply to covered members acting on behalf of any investment adviser registered with the SEC, required to be registered with the SEC, exempt reporting advisers (under Advisers Act Rule 204-4(a)) and unregistered advisers relying on the Advisers Act Section 203(b)(3) exemption for foreign private advisers. This coverage lines up with investment advisers subject to the Advisers Act rule.

What is a contribution?

The proposed rules' time-out provisions would be triggered by contributions made by a covered member or any of its covered associates (described below). Contributions include gifts, subscriptions, loans, advances, deposits of money or anything of value made for the purpose of influencing the election, addressing debt incurred in connection with such election, or transition or inaugural expenses. As with the Advisers Act rule, a donation of time would not be considered a contribution provided that the covered member did not solicit individuals to contribute their time and the covered member's office space, telephones and other resources are not used. Charitable donations by a covered member at the request of a government official or entity to an organization qualifying for an exemption from federal taxation would not constitute contributions.

What is an official of a government entity?

An official of a government entity includes an incumbent, candidate or successful candidate that can directly or indirectly influence the outcome of the hiring of an investment adviser by the government entity. An official of a government entity includes officials responsible for the appointment of persons responsible for the hiring of investment advisers. A "government entity" includes state and local governments, agencies and instrumentalities, and all public pension plans and other collective government funds, including participant directed plans such as 403(b), 457 and 529 plans.

What is a covered associate?

Covered associates of a member firm include general partners, managing members, executive officers and those performing similar functions at a member firm. Covered associates also include those who engage in distribution or solicitation activities with a government entity and their supervisors. Covered associates are also defined to include political action committees controlled by a covered member firm or any of its covered associates.

Are there exceptions or exemptions to the proposed FINRA Pay-to-Play Rules?

There is a de minimis contribution exception under the proposed rules where a covered associate's aggregate (per election) contributions to a government entity official are less than or equal to $350 where the covered associate is entitled to vote for the official and less than or equal to $150 where the covered associate is not entitled to vote for the official.

For new covered associates, the proposed rules provide an exception from the restriction on member firms if the new associate's contribution was made more than six months prior to becoming a covered associate of the covered member unless the covered associate engages in, or seeks to engage in, distribution or solicitation activities with such government entity on behalf of the covered member.

The proposed rules also provide an exception for covered members if the restriction is due to a contribution made by a covered associate and the covered member discovered the contribution within four months of being made, the contribution was less than $350 and the contribution was returned within sixty days of discovery. Covered members with 150 or fewer employees can only rely on this exception twice a year and other firms can only rely on this exception three times a year.

Additionally, the proposed rules provide an avenue for member firms to apply to FINRA from an exemption from the rules' two-year time out period. This provision is designed to give member firms an opportunity to cure the consequences of an inadvertent violation of the member firm or its covered associates.

What other activities are prohibited by the proposed FINRA Pay-to-Play Rules?

The proposed rules also prohibit covered members from:

- coordinating or soliciting any person or political action committee from making contributions to an official or government entity where the member firm is looking to engage in distribution or solicitation activities on behalf of an investment adviser;
- paying political parties of a state or locality of a government entity with which the member firm is looking to engage in distribution or solicitation activities on behalf of an investment adviser;
- soliciting investments in covered investment pools (e.g. hedge funds and other pooled investment vehicles) with a government entity on behalf of an investment adviser in a manner that would be a violation of the proposed FINRA Pay-to-Play Rules if it was for advisory services; and

- it or its covered associates doing anything indirectly that, if done directly, would result in a violation of the proposed FINRA Pay-to-Play Rules.

What are the consequences of violation of the proposed FINRA Pay-to-Play Rules?

In addition to the normal potential disciplinary actions resulting from a member firm violating FINRA rules, violations of the proposed rules would result in such covered members being prohibited from receiving compensation arising from related government entity distribution or solicitation activities from investment advisers, investment adviser pools or solicited government entities. Violations of the proposed rules would also require that the covered member pay any compensation or other remuneration received by the covered member pertaining to the distribution or solicitation activities during the two-year-time out period to (1) the covered investment pool in which the government entity was solicited to invest, (2) the government entity, (3) any appropriate entity designated in writing by the government entity if the government entity cannot receive the payment directly or (4) the FINRA Investor Education Foundation if the government entity cannot receive or designate payment to another entity. Further, member firms are prohibited from entering into arrangements with an investment adviser or government entity to recoup any such disgorged compensation.

Proposed Disclosure Requirements

The proposed rules also include disclosure requirements for covered members. Required disclosures to government entities must be in writing and include the name of the investment adviser, that the member is engaged in solicitation or distribution activities on behalf of the investment adviser, the nature of the affiliation and compensation arrangement between the adviser and covered member, a description of incremental charges or fees as a result of the solicitation, existence of any details regarding relationships between the covered member or any covered associate and persons affiliated with the government entity that has influence in the decision making process regarding the adviser, and the existence of the covered member's internal policies with respect to political contributions. Such disclosures to government entities must be updated in writing within ten days of any changes to the information if solicitation and distribution activities are ongoing.

Proposed Recordkeeping Requirements

The proposed rules impose recordkeeping obligations similar to those imposed upon investment advisers in connection with the Advisers Act rule. The proposed rules would require member firms to maintain a record of, among other things:

- the names, titles and addresses of all covered associates;
- names and addresses of all investment advisers on behalf of which the member firm has engaged in distribution or solicitation activities with a government entity in the last five years (but not prior to the proposed rules' effective date);
- name and business addresses of all government entities with which the member firm has engaged in distribution or solicitation activities on behalf of the investment adviser over the last five years (but not prior to the proposed rules' effective date);
- dates and amounts of all direct or indirect contributions made by the covered member or any covered associates to an official of a government entity, direct or indirect payments to a political party or to a political action committee; and
- details regarding any exceptions from the proposed rules that may be relied upon (e.g. exception for returned contributions).

Submitting Comments

FINRA is requesting comments on the proposed rules including, but not limited to, any potential costs and burdens of the rules. A list of particular questions is included in the FINRA notice linked above. You may submit comments to the FINRA by mailing a hard copy to the address shown in the release or by sending an e-mail to pubcom@finra.org. Comments must be received by December 15, 2014.

For More Information

To discuss any topic covered in this Client Alert, please contact a member of the Investment Management Group or visit us online at chapman.com.